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Can South Africa Afford to Become Africa's First Welfare State?

James Thurlow

South Africa's unacceptably low living standards have forced the government to attach great importance to its social security system. In 2000 the Department of Social Development commissioned the Taylor Committee to investigate the system's merits and shortcomings. One of the principal conclusions of the report is that existing social security programs inadequately address poverty. To close gaps in the system and encourage a better take-up of the available grants, the committee recommended comprehensive reform and the introduction of a basic income grant (BIG).

This universal grant would amount to R100 (US$10) per month, which would be paid to individuals in addition to any existing government transfers. Though the proposed phase-in would start with children under age 18, the transfer would eventually be made available to all South Africans regardless of age or income level. Such a policy move would make South Africa the first African welfare state.

The Basic Income Grant Debate

Three-quarters of adults and children in South Africa are not even indirect beneficiaries of the current social security system. Therefore a BIG of R100 per month represents a substantial increase in existing per capita transfers, and could help close the poverty gap by reaching the 13.8 million poorest South Africans who do not receive any form of social assistance. The anticipated benefits include increased productivity, increased supply of (and demand for) labor, and increased economic growth. Given that the BIG is equal to 5 percent of GDP, the ability of the grant to generate the above impacts is important, as long-term economic growth would certainly be needed to lessen its fiscal burden.

The magnitude of this spending has raised serious debate as to whether the country can afford the grant. Financing options include raising sales and income taxes, and reducing government spending on other policies. Given both the scale of the BIG and the contention surrounding its financing, this paper tries to assess which financing options are most feasible and what the impact of the grant and the suggested financing package will be on the South African economy.

The macroeconomic impact of financing a universal welfare program is likely to be as important in determining the program's merits as its ability to actually alleviate poverty.

The Model and the Data

This paper uses a computable general equilibrium (CGE) model for South Africa to determine the macroeconomic impact of implementing and financing a basic income grant. The model distinguishes between various institutions in the economy, including households, firms, the government, and the rest of the world. Each sectors' production, which is distinct from their produced commodities, combines the various factors and intermediates so as to maximize profit. Returns to these factors are paid to households who save their income or purchase consumer goods under utility maximization. Savings from institutions determine the level of investment in the economy.

South Africa is assumed to be a price-taker in international markets, and imperfect substitution is assumed between domestic and both imported and exported commodities. It is also assumed that the exchange rate is free to adjust and that the country is unable to increase foreign borrowing in order to finance the grant.

The model contains a complex system of prices and taxes. The government generates income through sales and import taxes on marketed commodities, and direct taxes on households and enterprises. The government spends this income on recurrent purchases, foreign borrowing, and transfers to households.

The BIG represents an increase in government transfers to households. In this paper it is assumed that the government cannot increase the budget deficit in order to finance the grant. According to the current policy debate, the government must therefore either increase sales or direct taxes, or decrease recurrent expenditure. This paper assesses the macroeconomic and distributional impact of each of these three financing options.

Results: Financing a Universal Grant in South Africa

Financing Through Increased Indirect Commodity Taxes. The first simulation finances the BIG solely through an increase in sales taxes on commodities. The impact of raising (already regressive) sales tax rates by the necessary 3.8 percentage points drives consumer prices up significantly. This negative impact on real household consumption spending is partially offset by the universal transfer from government to households. Moreover, low-income households benefit more from the transfer, since they comprise a larger proportion of the population receiving the BIG. On the other hand, since low-income households have lower savings rates, the shift in income toward these households reduces the overall level of real savings in the economy, which forces a decline in real investment spending, a shift away from investment, and a reduced level of import demand. The overall impact of the grant is a fall in real factor returns and employment and a reduction in real GDP of 0.8 percent.

Financing Through Increased Personal and Corporate Tax Rates. The next simulation evaluates the impact of the BIG if it were financed through an increase in direct tax rates on both households and enterprises. The initial impact of the additional transfer to households would raise the level of real private consumption. However, to maintain the budget deficit, the government is forced to raise revenue by increasing direct tax rates on domestic institutions by an average 4.4 percentage points. This resulting decrease in household disposable income partially offsets the increase in real consumption. The reduction in income in higher income households reduces the level of savings in the economy and decreases investment spending. This shift out of investment toward private consumption leads to an increase in demand for commodities purchased by low-income households. This change in the distribution of production leads to increased employment for unskilled labor and an increase in real factor returns for capital. Ultimately the BIG under this financing option has a small positive effect on GDP, which increases by 0.1 percent.

Financing Through Decreased Government Consumption Spending. A further financing option involves a shift in government spending toward transfers to households. As in the previous simulations, the initial impact of the grant is to raise private consumption demand. However, this increase is *not* offset by a reduction in private consumption—rather, the government reduces its consumption expenditure by 20.2 percent. Real private consumption increases, thus raising domestic production and exports.

Because the government carries the financing burden, there is less impact on the real consumption levels of high-income households. There is also a dampening of the redistribution effect on lower income households' real consumption, since government consumption spending, now reduced, is one of the largest employers of unskilled and semiskilled labor. Ultimately, there is a decline in real GDP of 1.3 percent.

A Financing Package. Each modeled financing option places significant pressure on various institutions within the South African economy. Since no individual option is likely to be economically or politically feasible on its own, the final simulation investigates the impact of a "balanced approach" that spreads the cost evenly over sales and income taxes and government consumption spending.

By removing the dependence on increased sales taxes, private consumption demand is not reduced by a rise in the consumer price index. The forced increase in the direct tax rates on households and enterprises is also lessened. Although there is no change in the distribution of the burden of the additional direct taxes, the distributional impact on real household consumption for higher income households is lessened. And while there is still a drop in employment, the overall negative effect is lessened through direct tax financing. Finally, while the scale of the grant remains unchanged, the burden of financing it is spread over domestic institutions. Thus, this option appears to be more politically and economically feasible than the others.

Conclusions

This study simulated the impact of the BIG under several scenarios. The results suggest that most advocates of the BIG have underestimated the required increases in sales and income tax rates and that a reduction in government consumption expenditure could undermine other programs. Given these often-negative impacts, more research should be undertaken to determine if a universal grant is indeed better than other targeted programs. However, if it is decided that a BIG is preferable to other poverty-alleviation policies, then this paper suggests that the current debate should undertake more rigorous macroeconomic analysis, and shift its focus away from determining which individual financing option should be implemented towards acknowledging that a "balanced" approach is likely to provide the only possible financing scenario.

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International Food Policy Research Institute

2033 K Street, N.W.
Washington, D.C. 20006 U.S.A.

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